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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

MEMORANDUM FOR: William F. Martin
National Security Council

FROM: [redacted] 25X1
Director of Global Issues

SUBJECT: OPEC: Internal Conflicts Promote
Market Instability [redacted] 25X1

Bill

Attached is our assessment of the outlook for OPEC's ministerial meeting scheduled to begin 16 March in Geneva. Since the group vowed last December to secure and defend a fair share of the market, oil prices have plummeted. Moreover, divergent views on the best way to reassert influence in the market have caused a serious split in OPEC. Competing self-interests probably will thwart a consensus agreement, but another inconclusive meeting could send prices even lower for an extended period. If you or members of your staff have questions concerning the report, please call [redacted] Chief, Strategic Resources 25X1
Division, [redacted] 25X1

[redacted] 25X1

Attachment:
<u>OPEC: Internal Conflicts Promote</u>
<u>Market Instability</u> [redacted] 25X1
GI M 86-20073, March 1986, [redacted] 25X1

[redacted] 25X1

[redacted] 25X1

SUBJECT: OPEC Internal Conflicts Promote Market Instability

OGI/SRD/EMB/gmf/1986 (10 March 1986)

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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

10 March 1986

OPEC: Internal Conflicts Promote Market Instability

Summary

OPEC oil ministers meet on 16 March in Geneva amid plummeting oil prices and market disarray. The major force propelling prices downward is OPEC's move--led by Saudi Arabia--to defend market share rather than prices. Divergent views on the best way to reassert influence in the oil market, however, have caused a serious strategy split in OPEC. The wealthy Arab producers lead a group intent on capturing a larger market share through fierce competition. A hardline faction, led by Iran and Libya, is blaming Saudi Arabia for the precipitous price drop and attempting to rally support for renewed production restraint in order to stabilize prices. If diplomatic pressures fail to convince Riyadh, Libya and Iran may resort to force. [redacted] 25X1

The members are also divided on whether now is the time to convene with a group of non-OPEC producers, even though a meeting has been scheduled immediately after the ministerial session. We believe that competing self-interests probably will preclude consensus and prevent a genuine exchange of views with non-OPEC producers. In that event, concerns about prolonged overproduction will create greater price volatility and, coupled with the expected seasonal downturn in demand, would cause oil prices to drop further--perhaps to as low as $10 per barrel--for a protracted period. [redacted] 25X1

This memorandum was prepared by [redacted] 25X1 Energy Markets Branch, Office of Global Issues. The information contained herein is updated to 10 March 1986. Comments may be directed to [redacted] Chief, Strategic Resources 25X1 Division, [redacted] 25X1

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OPEC: Internal Conflicts Hinder Market Stability

Recent Market Developments

OPEC production has increased to a point where it could trigger a new round of deep price cuts in coming weeks. In February, the organization's crude output averaged about 18 million b/d, an increase of 500,000 b/d over January levels (see Figure 1). Most of the rise was because of an increase in Saudi Arabia's production, although Nigeria and the UAE also stepped up output. The increase has come at a time when commercial oil stocks in the West are probably already above planned levels and just as the seasonal decline in consumption is about to begin. The combination of these events will generate a substantial oversupply by spring and increase downward pressure on prices. [redacted] 25X1

OPEC has been able to increase production because most of its members--acting in their own interests--have been more aggressive than their non-OPEC competitors in marketing their oil. Most OPEC nations have followed the Saudi lead in securing longer-term sales through netback deals--where the price of the crude is linked to the value of the products derived from it, thereby ensuring the refiners a profit. Only Venezuela, Indonesia, the UAE, and Ecuador have resisted engaging in these arrangements. Instead they have adopted new, more flexible pricing policies and are slashing prices on contract sales to keep up with spot prices (see Figure 2). [redacted] 25X1

Gearing Up for a Fight

At its December 1985 ministerial session in Geneva, OPEC established an ad hoc committee to define the group's fair share of the market and devise a means to defend it. [redacted] 25X1

[redacted] 25X1

OPEC recognizes that garnering a bigger share of the market means intense competition for sales, both from within the organization and from non-OPEC producers. Saudi oil, for example, has evidently displaced some Libyan oil in Western Europe. The Saudis also are landing new customers in the Far

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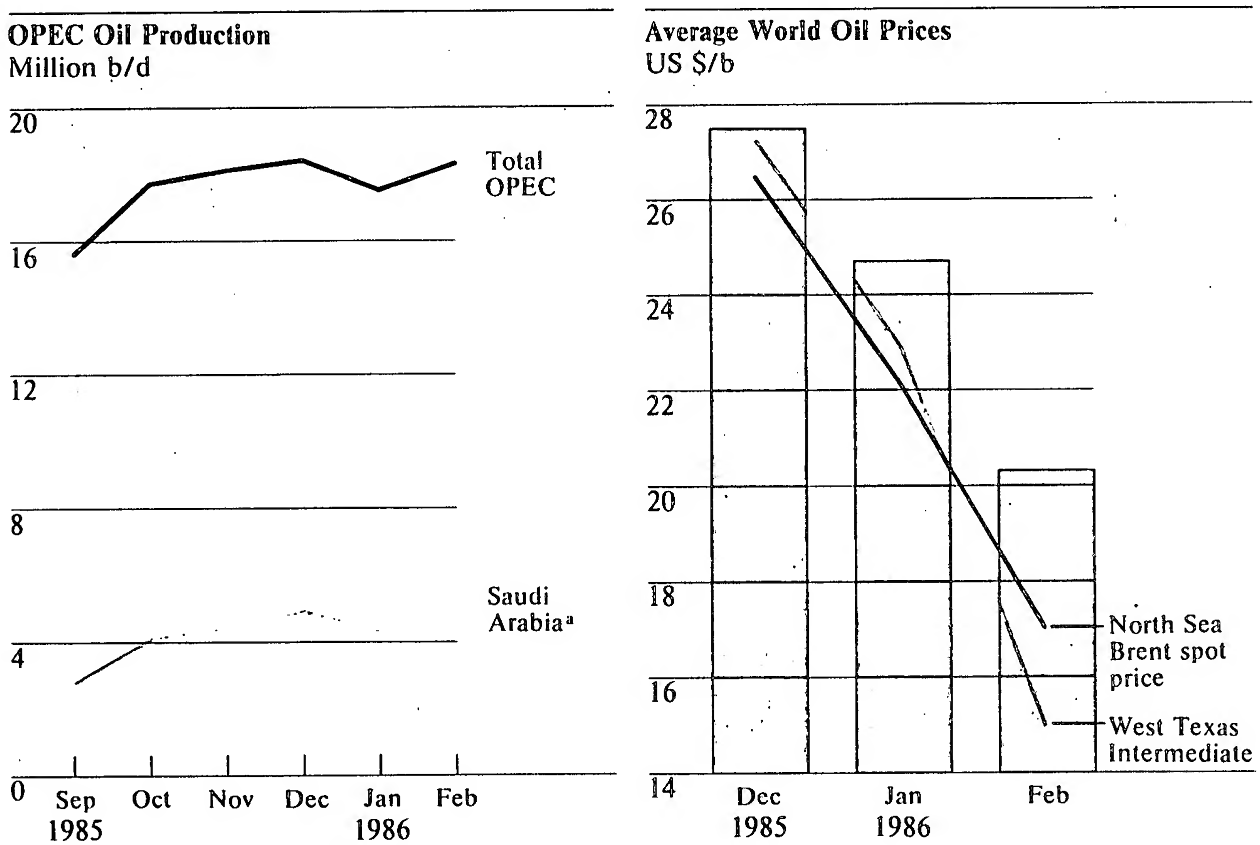
Figure 1

OPEC Oil Production and Average World Oil Prices



[a] Includes Neutral Zone production.

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East, largely at the expense of Iran. Moreover, OPEC knows that the uncertain reaction to its strategy by non-members has caused prices to fall to a point where an increase in OPEC's market share has not compensated for the fall in revenue. [redacted] 25X1

The ad hoc committee believes that cooperation will remain elusive and appears resigned to fierce competition. [redacted] 25X1 25X1

Factions are Emerging...and Also Threats

Unstable market conditions and aggressive, frenzied trading have caused bad blood within OPEC, and the members have split into two camps during the past month. Saudi Arabia, Kuwait, Iraq, and UAE, Qatar, and Indonesia favor staying the course of capturing a larger market share--according to public statements and US Embassy reporting--and appear prepared at this time to fight a prolonged price war with non-OPEC producers. With the exception of Iraq and Indonesia, this group is financially able to cope with the lower revenues which may result from an extended price war. Baghdad probably expects increased aid from its Arab benefactors will allow it to get by. [redacted] 25X1

Iran, Libya, Algeria, Nigeria, Gabon, Venezuela, and Ecuador want the group to restrain output in support of higher prices, according to press reports. These countries face serious impediments to rising output, or were losers in the early battle for market share. Furthermore, they have said that rapidly falling oil prices have rendered the previous strategy impractical and not worth the costs in terms of substantially lower oil revenues. In general, these producers also advocate coordination of oil policy with nonmembers. Indeed, Algeria, Libya, Nigeria, and Gabon recently announced that they formed the "African Hydrocarbon Association" within OPEC, and have asked all African producers--such as Egypt and Angola--to join. Finally, Venezuela has made some unprecedented statements this year regarding potential cooperation with Mexico and oil policies. [redacted] 25X1

Threats of reprisals also are emerging as some members become more desperate for oil revenue. Iran, Libya, and Algeria have publicly blamed Saudi Arabia for the current oil market crisis and have joined forces in a diplomatic offensive against Riyadh. [redacted] 25X1 25X1

If diplomatic pressures fail to convince Riyadh to restrain output, Libya and Iran may resort to force. Libyan leader

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Qadhafi publicly claimed that the Iran-Iraq war would expand to other countries in the Persian Gulf if the Saudis refuse to lower production. His remarks may already be setting the stage for an aggressive move. An Iranian Deputy Foriegn Minister recently implied in a press statement that Iran may soon begin attacking tankers carrying Saudi or Kuwaiti oil on Iraq's behalf. Tehran will continue to weigh carefully the risk of provoking Western military intervention, but, in our view, the threat to Iran's economy from declining oil revenues has increased its willingness to take such risks. [redacted] 25X1

The Saudi Strategy

Saudi Arabia appears determined not to retreat from its strategy of maintaining high export levels through netback deals, despite intimidation from Iran and Libya. The increase in Saudi oil earnings over the last several months has given the government some respite from additional budgets pressures. [redacted] 25X1

25X1

More ominous for OPEC at this stage is that Riyadh apparently believes that oil prices are still too high to force nonmembers to cut back output and to discourage development of alternative sources of energy. [redacted] 25X1

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The combination of popular domestic support for the Saudi stance in OPEC, and Riyadh's desire to lower prices to ensure a long-term market for its oil make it unlikely that Saudi Arabia will reverse course. The Saudis remain adamant not to shoulder the burden of stabilizing the market alone, but might once again restrain output if Riyadh becomes convinced that other producers will more fervently exercise production restraint. Sabotage of oil installations in the Kingdom, terrorism, or sharply lower oil prices over a long period, however, would prompt King Fahd to reassess his oil policy in our view. [redacted] 25X1

The Next Round

Attention is now directed towards Geneva on 16 March. The growing political discord within OPEC will make it difficult for consensus agreement on the best way to deal with plummeting oil prices (see Figure 3). OPEC does, however, have a history of

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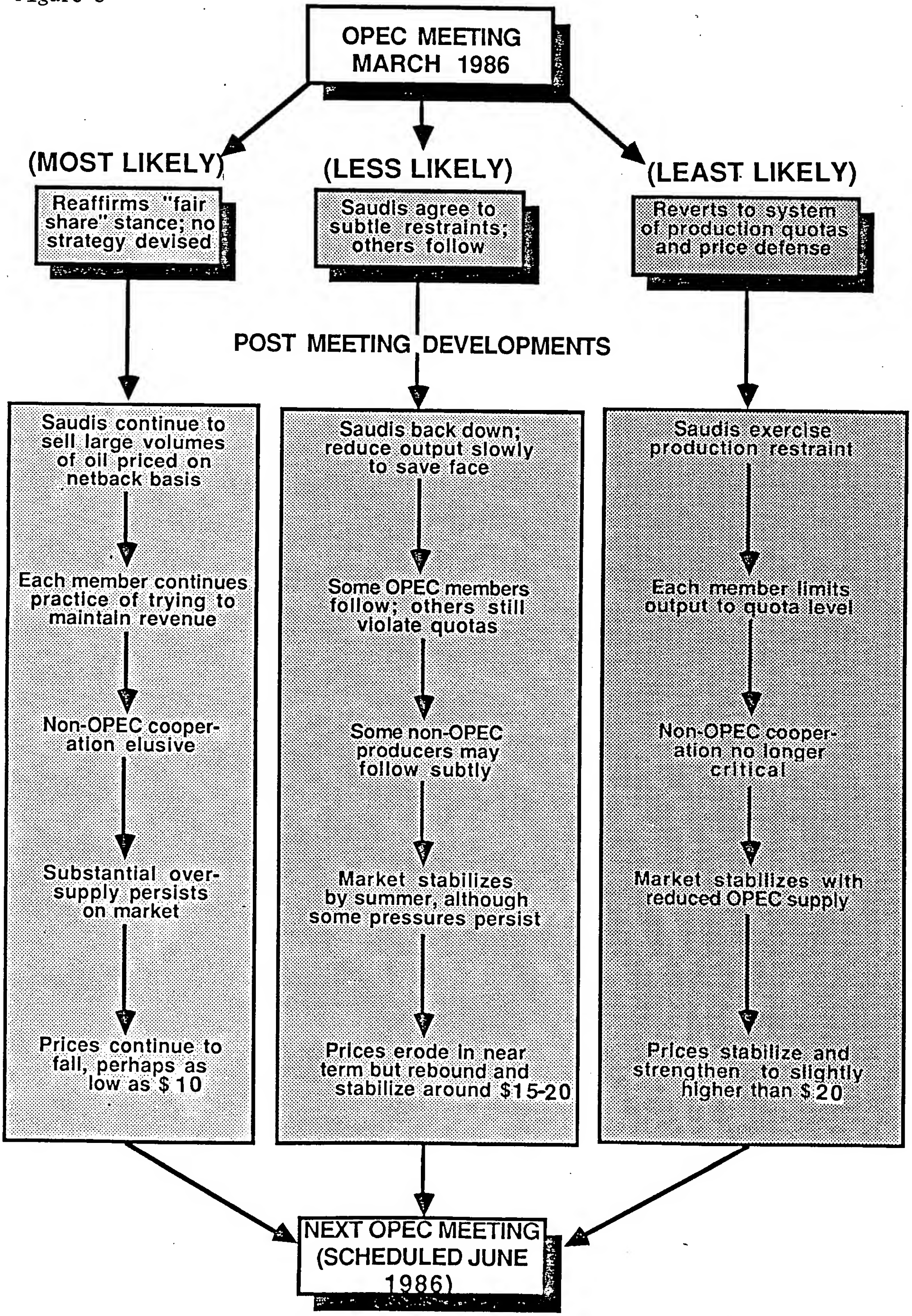
Figure 3



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closing ranks when confronted with a crisis. Saudi Arabia, moreover, is beginning to feel the political pressure from Iran and Libya. Indeed, the Saudi Ministry of Petroleum recently issued a statement that hinted--but stopped short of a promise--that Riyadh might step in to stop a price collapse. The statement also steered away from the confrontational tone previously used by Yamani against OPEC's primary non-OPEC targets--the UK and Norway. [redacted] 25X1

OPEC President Grisanti, from Venezuela, recently issued invitations to non-OPEC producers to meet with the cartel directly after the ministerial session, but only Mexico, Egypt, Oman, Malaysia and Brunei have agreed to attend. Some in OPEC, particularly Saudi Arabia, have recently claimed it is premature to hold such a meeting and reportedly plan to maintain "only a polite presence", [redacted] Realizing this, and 25X1 the absence of representatives from the UK and Norway, the non-OPEC producers may send lower-level representatives rather than oil ministers, [redacted] 25X1

In any event, another inconclusive OPEC meeting--the most probable outcome in our view--probably would leave the group deeply divided, fueling uncertainty about future production levels and greater price volatility. In that case oil prices could continue to fall sharply--perhaps to as low as $10 per barrel--for a protracted period. [redacted] 25X1

Implications

...**For the Oil Market.** Market psychology and uncertainties about OPEC's actions are likely to cause wide price fluctuations over the near-term. With little or no prospect for a substantial increase in demand for OPEC oil, competition among oil exporters will continue to put downward pressure on prices. Unless OPEC acts collectively to reduce output, prices will continue to erode. In the event OPEC loses all control over oil prices, the oil market would be guided by free market forces for the first time in fifty years. [redacted] 25X1

...**For OPEC.** So far, all OPEC members have not been willing to engage in an outright price war because of the risk of even greater losses. We believe that some OPEC members--especially Saudi Arabia--now view a price war as the most viable option to reassert influence in the market. Moreover, fierce competition for market share and the recent drop in oil prices, has put OPEC's future as an organization in jeopardy. [redacted] 25X1

...**For the US.** The prospect of lower oil prices will continue to be good news for the US economy. While the dissolution of OPEC and sharply lower prices would be economically beneficial for oil consuming countries in general, collapsing prices and volatile revenues would cause economic and political fallout in a number of oil exporting countries, threatening US strategic interests in several countries. [redacted] 25X1

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